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## Fiscal Policy At A Turning Point?

Responding to a slowdown in domestic growth and international pressure for a policy change, Japan's cabinet approved a major fiscal stimulus package on May 29. After several years of spending austerity aimed at reducing the public debt, the decision could represent a significant shift in policy. Two aspects of the proposal augur well for its acceptance by the Diet when an extraordinary session is convened in late summer: the controversial value-added tax proposal will not be included and popular income-tax cuts will be retained. The package, plus the June 2 decision to spend 80.1 percent of the public works funds already appropriated in the FY 1987 budget, should go a long way toward helping the economy achieve the 3.5 percent inflation-adjusted growth rate forecast for this fiscal year.

Japan Still The World's Top Net Creditor Nation

The Ministry of Finance reported last week that Japan's net foreign assets surged to a record $180.4 billion at the end of 1986, making it the world's largest creditor nation for the second consecutive year. Net overseas assets increased 39 percent from the $129.8 billion recorded at the end of 1985 (see Table 1), reflecting the investment abroad of its huge trade surpluses.

Table 1: Japan's Net External Assets

(in millions of dollars)

| End of Year | Private Sector | Government Sector | Total |
|---|---|---|---|
| 1978 | -$2,550 | $38,764 | $36,214 |
| 1979 | 850 | 27,927 | 28,777 |
| 1980 | -16,659 | 28,193 | 11,534 |
| 1981 | -18,537 | 29,455 | 10,918 |
| 1982 | 2,046 | 22,636 | 24,682 |
| 1983 | 11,928 | 25,331 | 37,259 |
| 1984 | 47,069 | 27,277 | 74,346 |
| 1985 | 104,450 | 25,371 | 129,821 |
| 1986 | 138,541 | 41,810 | 180,351 |

Source: Bank of Japan and Nihon Keizai Shimbun, May 26, 1987.

The current situation contrasts sharply with 1981, when the United States was the leading creditor nation and Japan's private sector had net liabilities of more than $18 billion. Three consecutive years of current account deficits in excess of $100 billion, though, have made this country the world's largest debtor nation. Although figures for 1986 are not yet available, it is estimated that U.S. net foreign liabilities increased to about $220 billion.

Japan's external assets increased 66.2 percent to $727.3 billion last year, while liabilities rose 77.7 percent to $547 billion (see Table 2). A sharp rise in the private sector's short-term borrowing accounted for most of the increase in liabilities. According to some analysts, Japanese banks have been borrowing short-term funds from abroad to help finance long-term investments overseas.

Japanese holdings of foreign securities, which rose 77 percent to $257.9 billion last year, now account for more than one-third of gross foreign assets. According to Brown Brothers Harriman & Co., dollar bonds accounted for more than 80 percent of total foreign bond purchases by Japanese investors in 1986. The large purchases of foreign securities have been encouraged by financial liberalization measures, intended in part to slow the appreciation of the yen. Prior to April 1986, for example, trust banks and life insurance companies, which are major purchasers of foreign securities, were only allowed to invest a maximum of 10 percent of their total funds in foreign assets. That ceiling is

now 30 percent. Continued financial liberalization is likely to further spur investment abroad. On May 27, for example, the Diet passed legislation allowing the Ministry of Posts and Telecommunications to raise the percentage of foreign assets in its Y31.8 trillion ($227.3 billion at Y140=$1.00) postal pension and insurance fund from 10 percent to 20 percent.

Table 2: Japan's External Assets and Liabilities

(in millions of dollars)

| | Assets | | Liabilities | |
|---|---|---|---|---|
| | End of 1985 | End of 1986 | End of 1985 | End of 1986 |
| Long-term | $301,297 | $476,136 | $122,328 | $192,336 |
| Private sector | 264,458 | 424,704 | 91,776 | 152,192 |
| Direct investment | 43,974 | 58,071 | 4,743 | 6,514 |
| Trade credits | 23,603 | 31,992 | 131 | 33 |
| Loans | 46,870 | 69,211 | 1,211 | 1,199 |
| Securities | 145,748 | 257,933 | 84,847 | 143,611 |
| Others | 4,263 | 7,497 | 844 | 835 |
| Government sector | 36,839 | 51,432 | 30,552 | 40,144 |
| Trade credits | 1,062 | 1,423 | 0 | 0 |
| Loans | 23,293 | 33,558 | 84 | 66 |
| Others | 12,484 | 16,451 | 30,468 | 40,078 |
| Short-term | 136,404 | 251,170 | 185,552 | 354,619 |
| Private sector | 108,753 | 207,876 | 176,985 | 341,847 |
| Monetary movements | 99,719 | 194,713 | 160,984 | 322,163 |
| Others | 9,034 | 13,163 | 16,001 | 19,684 |
| Government sector | 27,651 | 43,294 | 8,567 | 12,772 |
| Monetary movements | 27,650 | 43,294 | 4,557 | 7,103 |
| Others | 1 | 0 | 4,010 | 5,669 |
| Total | 437,701 | 727,306 | 307,880 | 546,955 |

Source: Nihon Keizai Shimbun, May 27, 1987.

Direct foreign investment assets also rose sharply, hitting $58.1 billion at the end of 1986. The increase reflects stepped-up efforts by Japanese industries to shift production to other countries in an attempt to cushion the impact of the high yen. According to a MOF report, direct foreign investment hit a record $22.3 billion in FY 1986 (April 1, 1986-March 31, 1987) compared to $12.2 billion the preceding fiscal year. Much of the increase was due to a sharp rise in real estate investments in the United States, which soared from $1.1 billion in FY 1985 to $3.7 billion in fiscal 1986.

Japan's position as the leading creditor nation is reflected in its declining deficit in services (see Table 3). In the early 1980s, Japan's service deficit nearly matched its surplus in merchandise trade. The swing in net investment income from a net outflow in 1981 to a $9.5 billion inflow last year, though, reduced the deficit on trade in services to under $5 billion.

Table 3: Japan's Trade Balance in Services

(in millions of dollars)

| Year | Investment Income | | Other Services | Total |
|---|---|---|---|---|
| | Total | Direct | | |
| 1978 | $900 | $376 | -$8,287 | -$7,387 |
| 1979 | 2,011 | 345 | -11,483 | -9,472 |
| 1980 | 854 | 809 | -12,197 | -11,343 |
| 1981 | -763 | 816 | -12,810 | -13,573 |
| 1982 | 1,718 | 992 | -11,566 | -9,848 |
| 1983 | 3,082 | 1,354 | -12,188 | -9,106 |
| 1984 | 4,231 | 1,428 | -11,978 | -7,747 |
| 1985 | 6,840 | 1,711 | -12,005 | -5,165 |
| 1986 | 9,473 | 1,412 | -14,405 | -4,932 |

Source: Bank of Japan

Randall S. Jones

JDA Director General Visits China

Yuko Kurihara last week became the first head of the Japan Defense Agency to visit the People's Republic of China, another indication of efforts to forge sound across-the-board relations despite continued friction over trade matters. While the talks were significant in terms of defense, they were more important in outlining the overall relationship between the two countries.

China has been critical of Tokyo's defense policies and indeed of any policy that Peking perceives as a reminder of Japan's legacy of the 1930s. The PRC launched intense protests when Japanese textbooks softened their treatment of the invasion of China. A senior Chinese defense official cancelled a scheduled visit to Japan in 1985 to protest visits by Japanese government officials to the Yasukuni Shrine, which is dedicated to the memory of military figures. And Tokyo's recent decision to lift its limit on total defense spending precipitated additional outcries from China's leadership.

Economic frictions have complicated the picture as well. Bilateral trade overwhelmingly favors Japan, and there is no prospect for significant changes in the near future. Furthermore, China has been very critical of Japanese investment policies, insisting that overall amounts are insufficient and charging that firms refuse to provide more advanced technologies that are essential to economic development. Political tensions have also surfaced in recent weeks after the government expelled a Japanese reporter on espionage charges.

Mr. Kurihara used the occasion to ease any fears of revived Japanese militarism. In statement after statement, he insisted that Japan's defense program is intended solely to defend the country and said that the gradual buildup would not mean unrestrained spending in the future. The Japanese